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No. 82-716

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

THE EL PASO COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF CHEMICAL MANUFACTURERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Of Counsel:
DAVID F. ZOLL
Chemical Manufacturers Association
2501 M Street, N.W.
Washington, D.C. 20037
(202) 887-1100

RAPHAEL SHERFY
(Counsel of Record)
ROBERT D. HEYDE
MILLER & CHEVALIER, Chartered
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 626-5600

Counsel for Amicus Curiae Chemical Manufacturers Association

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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The Chemical Manufacturers Association (CMA) submits this brief *amicus curiae* in support of the petition for a writ of certiorari filed by The El Paso Company. CMA supports this Court's review of all of the issues presented by the petition.[1]

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[1] Written permission from the parties to this litigation to file this brief as *amicus curiae* has been obtained and has been filed with the Clerk of this Court.

INTEREST OF THE AMICUS CURIAE

The Chemical Manufacturers Association is a nonprofit trade association representing more than 90 percent of the production capacity of basic industrial chemicals within this country. The El Paso Company, the petitioner in this case, is a holding company of several corporations, one of which, The El Paso Products Company, is a member of CMA.

A divided panel of the United States Court of Appeals for the Fifth Circuit in this case affirmed the judgment of the United States District Court enforcing an Internal Revenue Service (IRS) summons issued to The El Paso Company, calling for the production of its "taxpool analysis", an analysis made by The El Paso Company to determine the adequacy of its reserves for contingent tax liabilities and comply with the financial reporting requirements of the securities laws. The court held, in pertinent part, that the taxpayer's tax pool analysis, and any supporting memoranda used in its preparation, summoned by the IRS were relevant to determining the correctness of certain of El Paso's tax returns, that the tax pool analysis and such supporting memoranda were protected neither by the attorney-client privilege nor by the work-product doctrine, and that the public policies reflected in federal securities laws did not require denial of enforcement of the summons.

The Fifth Circuit's decision is of vital importance to chemical companies, as it is to all publicly-held corporations. Many CMA member companies are large, publicly-held companies engaged in a myriad of complex transactions on a worldwide basis. As a result, the ultimate tax liability of each company is also a complex determination, and reserves must be established to provide for any contingent liability. The judgments, opinions, and thought processes of company officials as to the likelihood and amount of that liability should not be discoverable by the Internal Revenue Service.

ARGUMENT

This case, along with *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (1982), petition for cert. filed, No. 82-687 (Oct. 20, 1982), involves the limits of the summons power of the Internal Revenue Service under 26 U.S.C. § 7602. The issues involved in the two cases are extremely important in the administration of the tax laws, and if the summons power is upheld in these cases, the scope of Internal Revenue Service audits would be redefined. Additionally, disclosure of contingent tax liabilities by publicly-held corporations would, to the detriment of the investing public, be less open.

The initial and primary question presented by the case is the relevance in an IRS audit of a taxpayer's tax pool analysis. The Fifth Circuit has defined relevance so broadly as to have very few limits. The term has been defined as an absolute, without regard to the circumstances of its application. CMA maintains that relevance must be examined in the context of public policy and with due regard to all surrounding circumstances. This case therefore presents the Court with an opportunity to consider whether there are meaningful limits to relevance in IRS audits and whether public policy and other balancing factors might affect those limits.

The tax pool analysis is not prepared as part of, or in furtherance of, a taxpayer's tax return. The tax pool analysis is often not prepared contemporaneously with the tax return. In simplest terms, the tax pool analysis is merely an estimate of a company as to what its final tax liability may be after all gray areas are resolved in the audit and subsequent administrative and judicial processes. The format and detail of the tax pool analysis may differ among taxpayers, but The El Paso Company's tax pool analysis appears typical. That analysis identifies questionable issues, speculates on the likelihood that those issues will be raised, evaluates the merits of the issues,

projects a future settlement posture, and estimates the overall final outcome.

It is important to note that a tax pool analysis may not include facts or data that were used in preparation of the tax return or that bear on final tax liability. It is this non-factual material that is involved in this case. The only claim of relevance that can be made as to this material is that the tax pool analysis provides a convenient roadmap for expeditiously auditing a taxpayer's return.

The definition of relevance used by the Fifth Circuit in this case, as well as by the Court of Appeals in the *Arthur Young* case, is whether the document sought "might throw light upon the correctness of the taxpayer's return". 682 F.2d 537, quoting *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981). This test of relevance is extremely broad and contrary to the test adopted by the Tenth Circuit in *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (1977). The Tenth Circuit applied a balancing test of relevance rather than considering the term as an absolute. In effect, relevance must be tempered by the context in which it is applied.

The relevance of the tax pool analysis to the Internal Revenue Service is very limited. If the analysis is not available to the IRS, the IRS is still able to complete a thorough audit. The analysis is not necessary to completion of the audit; it would merely speed up a determination of issues that should be closely examined. At the same time, availability of the analysis to the IRS would unfairly give the IRS the taxpayer's own judgment of its settlement and litigating positions.

All persons familiar with our federal tax system know that the tax laws are extremely complex and that there are many questions of application and interpretation that have yet to be decided. On every large corporate tax return, there are questions of proper tax treatment that have no definite answer. Our self-assessment system re-

quires that answers be given in preparing the tax return, but it does not require that the answers on the return be resolved unfavorably to the taxpayer. The taxpayer is entitled to interpret the law in its favor, and an extensive administrative and judicial process has been established to resolve differing interpretations. On a practical level, experience shows that a taxpayer is severely disabled in that administrative and judicial process if its evaluations of its strengths and weaknesses and its settlement and litigating positions are known to the government. There is a sense of unfair play in giving the government such knowledge.

It is in this context of the impact on our self-assessment system that the relevance of the tax pool analysis must be judged. That relevance must also be considered in the light of its impact on the federal securities laws.

The tax pool analysis is required in order that an independent auditor may certify a company's financial statements, which must be periodically filed with the Securities and Exchange Commission. If the tax pool analysis is not subject to IRS summons, as has been generally believed until recently, the taxpayer company has no reason to hold back in its discussions with its independent auditors from a frank and complete disclosure of its evaluations and judgments on all potential tax issues. This means that the investing public will receive the benefit of the best financial information available concerning a company. If this Court should hold that the tax pool analysis is subject to summons by the IRS, companies will still meet their financial reporting requirements but not to the full extent that they now disclose. There is a wide range of discretion in determining the extent of disclosure under current auditing standards, and companies will certainly be more guarded in their disclosure policies if such information is ultimately available to the Internal Revenue Service.

As the petition for certiorari points out, the issue of the availability of the tax pool analysis has been the subject of much public comment in recent years. Proposals have been advanced for requiring taxpayers on their tax returns to identify questionable items. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress did not adopt such a requirement but did adopt a more limited provision to encourage taxpayers to set forth questionable items. In section 323(a) of that Act (codified at 26 U.S.C. § 6661), a penalty is provided for substantial underpayments of tax, but the penalty will not apply if the taxpayer has adequately disclosed the relevant facts respecting its return position or if there is substantial authority for that position. Note that the disclosure is of relevant *facts* and does not involve estimates, evaluations, or judgments of a taxpayer's position. The summons authority of the Internal Revenue Service found in 26 U.S.C. § 7602 must be viewed through this recent indication of Congressional intent.

If the primary question of relevancy is decided in favor of upholding the IRS summons, this case raises the no less important issue of the applicability of the work product privilege. The Second Circuit in the *Arthur Young* case held that a work product privilege protects the tax pool analysis from a summons (except for a sufficient showing of need). The summons in *Arthur Young* was directed to the independent auditors, and if the work product privilege as set forth in *Arthur Young* is upheld, it must be decided whether that privilege extends to a tax pool analysis prepared by, and in the hands of, a taxpayer. If the privilege does not so extend, then it is of little value.

A further important question is raised by the petition. The El Paso Company's tax pool analysis was prepared under the direction of lawyers. The Court of Appeals held that any attorney-client privilege that might have arisen in such circumstances is waived by disclosure of

the analysis to the outside auditor, even though the auditor is under strictures of confidentiality and even though the disclosure is effectively required by federal law. Such a holding places severe limitations on the modern-day usefulness of the attorney-client privilege, and this Court should review the holding.

CONCLUSION

The El Paso Company's petition for a writ of certiorari should be granted.

Respectfully submitted,

Of Counsel:
DAVID F. ZOLL
Chemical Manufacturers Association
2501 M Street, N.W.
Washington, D.C. 20037
(202) 887-1100

RAPHAEL SHERFY
(Counsel of Record)
ROBERT D. HEYDE
MILLER & CHEVALIER, Chartered
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
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